# TAX REFORM 1969: THE ESTATE TAX CHARITABLE DEDUCTION AND THE PRIVATE CHARITABLE FOUNDATION*

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## PART I: CHARITABLE DEDUCTION—FEDERAL ESTATE TAX

The charitable deduction is allowable under IRC 2055. This statute has been amended by the addition of sub-section (e)—"Dissallowance of Deductions in Certain Cases."

### 1. *Qualification of Transferee*

#### A. Recognition

Paragraph (e)(1) deals with the qualifcation of the organization or trust which will receive the gift, as a condition to the allowance of the deduction. The transferee must be in compliance with IRC 508(d) disallowing the deduction for transfers to organizations which have violated the new rules applicable to private foundations or failed to apply for recognition as an exempt organization. IRC 508(d) applies generally to all charitable deductions, for Income and Gift tax purposes, as well as Estate tax. The recognition procedure is left to Treasury regulations and the deadline for filing the required application or notice will not expire until 90 days after the regulations become final.

#### B. Governing Instrument

Certain restrictions must be included in the "governing instrument" of a private foundation or charitable trust. This is also a condition precedent to the allowance of a charitable deduction. Under IRC 508(e) the governing instrument must include provisions the effect of which are:

> (A) to require its income for each taxable year to be distributed at such time and in such manner as not to subject the foundation to tax under section 4942, and
>
> (B) to prohibit the foundation from engaging in any act of self-dealing (as defined in section 4941(d)), from retaining any excess business

* This article is adapted from a special supplement to J. S. PLATT, ESTATE PLANNING: OHIO (1969), copyright 1970 by The Bobbs-Merrill Company, Inc. and is reprinted by permission of the publisher. The supplement deals with the Tax Reform Act of 1969—the new federal Income, Estate and Gift Tax Rules which are pertinent to estate planning. The author has asked us to print the following introductory paragraph:

> This supplement was prepared before the issuance of any Treasury regulations interpreting, explaining, and implementing the new rules. The practical suggestions scattered through this material should be considered as short-term recommendations to be reviewed and rechecked by the reader in the light of subsequent rulings and announcements by the Internal Revenue Service and the regulations as they are proposed by the Treasury.

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> holdings (as defined in section 4943(c) ), from making any investments in such manner as to subject the foundation to tax under section 4944, and from making any taxable expenditures (as defined in section 4945(d) ).

For any foundation or trust organized before January 1, 1970, the "governing instrument" requirement will not apply to any taxable year beginning before January 1, 1972. No grace period is allowed for new organizations. It will be important to include the provisions required by IRC 508(e) in the basic documents of every newly organized charitable foundation.

The governing instrument rule, with some modifications, is also applicable under IRC 4947 to certain non-exempt charitable trusts—testamentary or inter vivos trusts which have both charitable and non-charitable beneficiaries. The implementation of this rule is left to Treasury regulations. In the meantime—until the regulations are proposed—it may be advisable to refer to this requirement in the basic document (trust agreement or will) of any trust which will hold assets for which a charitable deduction will be allowable to a donor or decedent's estate for Income, Estate or Gift tax purposes—assets which are to be administered or distributed, presently or in the future, for charitable purposes.

The complete statement under 508(e), quoted above, should be in effect *when all non-charitable interests have terminated*, i.e., when the interests of all individual annuitants terminate and the charitable remainder becomes effective. From and after the death of the surviving annuitant, when the trust is to be administered or distributed solely for charitable purposes or beneficiaries, it is treated as a charitable *organization* subject to the rules of IRC 508. This treatment is provided for by paragraph (1) of IRC 4947(a).

The application of the governing instrument rule to split-interest trusts *before all the non-charitable interests have terminated* is provided by paragraph (2) of IRC 4947(a). This refers to a trust in which the charity has a terminable interest followed by a non-charitable remainder or where a charitable remainder is subject to a present non-charitable annuity. The meaning of this statutory paragraph is not entirely clear. For the present, until regulations are proposed, it may be advisable to refer specifically to IRC 4947(a)(2) in the instrument with a statement to the effect that the trustee shall be governed by the requirements of IRC 508(e) to the extent applicable to this trust. The following statement is suggested:

> The trust will hold assets or amounts for which a charitable deduction has been allowed to a contributor, donor or decedent's estate for federal Income, Gift or Estate tax purposes. The trustee shall make application for recognition of the trust as an organization described in IRC 501(c)(3) effective on the first date when all of the unexpired interests in the trust are devoted to one or more of the purposes described in IRC 170(c)(2)(B)

(charitable purposes). From and after said date the trust shall be governed by the following requirement and prohibitions:

(Requirement)—the trust income shall be distributed at such time and in such manner as not to subject the trust to tax under IRC section 4942.

(Prohibitions)—the trust shall be prohibited from engaging in any act of self-dealing (as defined in IRC section 4941(d) ), from retaining any excess business holdings (as defined in IRC section 4943(c) ), from making any investments in such manner as to subject the foundation to tax under IRC section 4944, and from making any taxable expenditures (as defined in IRC section 4945 (d)).

Prior to the date mentioned in the preceding paragraph, while there are unexpired interests in the trust which are devoted to purposes other than those described in IRC 170(c)(2)(B), the trustee shall be governed by the prohibitions stated in the preceding paragraph to the extent applicable to a split-interest trust described in IRC 4947 (a)(2).

2. *Charitable Remainders*

Paragraph (2) of new subsection IRC 2055(e), limiting the Estate tax deduction, deals with the required form of the charitable transfer to a split-interest trust, where the charitable interest is a remainder following a term or lifetime interest in a non-charitable beneficiary. The rules are new.

The value of a charitable remainder is no longer deductible unless the trust qualifies as a "charitable remainder annuity trust" or a "charitable remainder unitrust" or a "pooled income fund." In the case of the first two the intervening non-charitable interest must be stated in terms of a dollar annuity, distributable each year: an annuity based on a percentage (at least 5%) of the starting corpus (annuity trust) or an annuity based on a percentage (at least 5%) of the corpus as re-valued each year (unitrust). The value of the intervening interest (and the remainder) will be measurable in dollars at the decedent's death, and the remainder will be protected against diversion by investment policies favoring the non-charitable beneficiary. At the same time the 5% pay-out requirement will avoid any substantial income accumulation during the intervening years. The theory is that, once a charitable deduction has been allowed, the value committed to charity must be protected against diversion and the income attributable to this value must not be accumulated.

The "pooled income fund" is discussed below.

The *annuity trust* is defined in IRC 664(d)(1) as follows:

(1) CHARITABLE REMAINDER ANNUITY TRUST.—For purposes of this section, a charitable remainder annuity trust is a trust—

(A) from which a sum certain (which is not less than 5 percent of the initial net fair market value of all property placed in trust) is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in subparagraph (A) may be paid to or for the use of any person other than an organization described in section 170(c), and

(C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use.

The *unitrust* is defined in the IRC 664(d)(2) as follows:

(2) CHARITABLE REMAINDER UNITRUST.—For purposes of this section, a charitable remainder unitrust is a trust—

(A) from which a fixed percentage (which is not less than 5 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in subparagraph (A) may be paid to or for the use of any person other than an orginization described in section 170(c), and

(C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use.

In the case of the *unitrust* the instrument may provide that the non-charitable beneficiary W is to receive income only, if this is less than the fixed percentage, with the deficiency to be made up in years when the income is higher than the fixed percentage, IRC 664(d)(3). This is intended to add administrative flexibility—to make it possible for the trustee to make the required payments to the non-charitable annuitant out of income, without selling any capital assets. The actual payments to the annuitant may be less than 5% if this provision is included since the payment deficiency at W's death is not recovered by her estate. Nevertheless the charitable deduction for the remainder must be calculated regardless of this provision on the assumption that the maximum 5% annuity is payable to the non-charitable annuitant. See (8) below. For this reason, if D intends to reserve for W all value which cannot be deducted, he will not make use of this flexibility provision.

In the case of the *unitrust* the annuity is a fluctuating amount based on an annual appraisal of the trust assets. This will complicate the administration of any trust holding assets other than cash accounts and listed securities. The report of the House Ways and Means Committee states that the deduction may be disallowed where the trust holds real estate or stock in a closely held corporation "unless an independent trustee is the sole party responsible for making the annual determination of value."

Note the requirement of Clause (C) in both definitions (annuity and unitrust). The entire remainder interest must pass to charity. A separate trust should be established for any portion of the estate which is to pass, at the termination of a life or term interest, to a non-charitable distributee.

*Examples:*

*Non-deductible Remainder*

Property in trust—income to W for life, remainder to charity.

*Deductible Remainders*

A. (Annuity Trust) Property in trust—annuity equal to 5% (or a higher percentage) of the initial fair market value to be paid annually (or more often) to W for life, remainder at W's death to charity.

B. (Unitrust) Same facts, except that the non-charitable interest is a variable based on 5% of the fair market value of the assets, valued annually.

Notes (1) The non-charitable period in either A or B may be measured by two or more lives of persons living when the trust is created, or may be for a term of not more than 20 years.

(2) The entire remainder must pass to charity at the end of the non-charitable period.

(3) The unitrust in B may provide that W is to receive income only if less than 5%, the deficiency to be made up in subsequent years prior to W's death when income is higher than 5%.

For Estate tax purposes these rules will not be applicable unless the non-charitable annuitant survives the decedent. If the interest of the charity vests as a present interest at D's death because of the prior death of W, the annuitant or successor annuitant, the limitations on the deductibility of a charitable remainder will be irrelevant. The same result will follow from a timely disclaimer of the annuitant's interest. See (10) below.

3. *Remainder Interest in Residence*

The charitable remainder rule of IRC 2055(e) contains an exception in favor of "a remainder interest in a personal residence or farm." The Estate tax statute does not include a provision for valuing such a future interest for purposes of the charitable deduction. However a valuation formula is provided in IRC 170(f)(4), the new Income Tax rule on the deductibility of charitable remainders:

> (4) VALUATION OF REMAINDER INTEREST IN REAL PROPERTY.—For purposes of this section, in determining the value of a remainder interest in real property, depreciation (computed on the straight line method) and depletion of such property shall be taken into account,

> and such value shall be discounted at a rate of 6 percent per annum, except that the Secretary or his delegate may prescribe a different rate.

This valuation formula will presumably be applied in valuing a remainder interest in a personal residence or farm for purposes of the Estate tax charitable deduction. (See (7) below.)

### 4. *Undivided Interests*

The charitable remainder rule of IRC 2055(e) does not apply to an undivided portion of the decedent's entire interest. Where the charity is given an outright present interest in a fractional or percentage share of the decedent's property the fact that non-charitable legatees are given fractional shares in the same property does not bar the charitable deduction.

### 5. *Pooled Income Fund*

This form of transfer is defined in IRC 642(c)(5) as follows:

> (5) DEFINITION OF POOLED INCOME FUND.—For purposes of paragraph (3), a pooled income fund is a trust—
>
> (A) to which each donor transfers property, contributing an irrevocable remainder interest in such property to or for the use of an organization described in section 170(b)(1)(A) (other than in clauses (vii) or (viii) ), and retaining an income interest for the life of one or more beneficiaries (living at the time of such transfer),
>
> (B) in which the property transferred by each donor is commingled with property transferred by other donors who have made or make similar transfers,
>
> (C) which cannot have investments in securities which are exempt from the taxes imposed by this subtitle,
>
> (D) which includes only amounts received from transfers which meet the requirements of this paragraph,
>
> (E) which is maintained by the organization to which the remainder interest is contributed and of which no donor or beneficiary of an income interest is a trustee, and
>
> (F) from which each beneficiary of an income interest receives income, for each year for which he is entitled to receive the income interest referred to in subparagraph (A), determined by the rate of return earned by the trust for such year.

This definition is designed to cover the life income contract. Universities and other organizations issuing such contracts will be reviewing their plans in the light of IRC 642(c)(5). The authority to hold non-taxable securities will be eliminated (Clause C), all separate funds of particular donors will be merged (commingled) with the general fund (Clause B), any endowment and other funds now included in the fund will be removed for separate administration (Clause D), and any other modifications needed to satisfy the definition will be made.

6. *Gift-Annuity Plan*

The gift-annuity plan involves the outright transfer of property to charity in consideration for an annuity contract—a combination sale and gift transaction. Therefore it is not subject to IRC 2055(e)—or to the corresponding Gift and Income tax statutes, IRC 2522(c) and 170(f). These statutes deal with remainder interests, where the charity's ownership is deferred until the termination of a life or term interest in a non-charitable beneficiary.

7. *Valuation*

According to the statute (IRC 664(e) ) the charitable deduction for the remainder interest in an *annuity* or *unitrust* is computed by assuming that 5% of the net fair market value of the assets is to be distributed each year to the non-charitable beneficiary. The Ways and Means Committee Report (page 59) gives the following example:

> Assume a donor makes a completed gift of $100,000 to a trust which provides for a $5,000 annuity to A for life and the remainder to charity. With a 3½-percent discount rate, the present value of the income interest would be valued by determining A's life expectancy and discounting the annual $5,000 payments by 3½ percent. This amount, when subtracted from the total value of property transferred, would indicate the present value of the charitable remainder. If, on the other hand, the trust was a unitrust which specified a payout of 5 percent of the fair market value of the trust property each year, A's interest would be determined (as was the value of A's annuity) on the assumption that each year the trust will earn 3½ percent on the existing fund and will, therefore, be distributing principal to the extent of 1½ percent each year (a declining balance calculation). The fact that under the unitrust A may actually receive more or less than $5,000 each year depending on the success of the investment is irrelevant in determining his relative interest in the given amount ($100,000) that must be allocated between his interest and the charitable remainder interest.

The final result in either case will depend on the life expenctancy tables and the discount rate which are used in valuing the annuity interest.

On the basis of the 3½% tables in the Estate Tax Regulations (Sec. 20.2031-7), an annuity of $5,000 (5% of $100,000 corpus) for a beneficiary age 60 is worth almost $56,700. The charitable deduction is therefore worth $43,300.

By way of comparison the value of a life income interest for a person age 60 in a corpus of $100,000 under the present Estate Tax Tables is about $39,700, indicating a value for the charitable remainder of $60,300. Longer life tables are prescribed under IRC 72, the annuity statute. According to this table a female age 60 has a life expectancy of 21.7 years. If this expectancy table is used for valuing annuities under IRC 2055(e) the deduction for a charitable remainder will be further reduced. The 22 year factor in the Estate tax table is 15.1671. On this basis the $5,000 annuity would be worth about $75,000, reducing the charity's interest to $25,000.

In view of the larger charitable deduction allowable under the common life income-remainder arrangement, there is something to be said for keeping existing wills and trusts, executed on or before October 9, 1969, in effect for the time being. But the document must not be re-published or amended until the time comes to comply with the new rules and this must be done not later than October 9, 1972. (See discussion of effective dates below.)

The rules for valuing a remainder interest in a *personal residence or farm* are even more restictive. Assuming that IRC 170(f)(4) will be applied for Estate tax purposes the value of the remainder is to be discounted at 6% after deducting straight line depreciation on the buildings. Note that the value of the future gift must be reduced for depreciation even though the taxpayer's residence is not depreciable for Income tax purposes. If the expectancy of the life tenant is more than a very few years the value of the deductible remainder interest may approach the vanishing point.

The charitable deduction for a transfer to a *pooled income fund* is determined under the final paragraph of IRC 642(c)(5), as follows:

> For purposes of determining the amount of any charitable contribution allowable by reason of a transfer of property to a pooled fund, the value of the income interest shall be determined on the basis of the highest rate of return earned by the fund for any of the 3 taxable years immediately preceding the taxable year of the fund in which the transfer is made. In the case of funds in existence less than 3 taxable years preceding the taxable year of the fund in which a transfer is made, the rate of return shall be deemed to be 6 percent per annum, except that the Secretary or his delegate may prescribe a different rate of return.

The use of the 6% discount rate will generally be unfavorable since these funds are unlikely to show an overall income yield as high as 6%. The actual record for the three prior years, assuming that it indicates an annual pay-out to the non-charitable beneficiary lower than 6%, will give a higher charitable deduction for the remainder interest at D's death.

The valuation rule based on income yield during three prior years of operations may be affected by the present status of the fund. Many existing income funds will not satisfy the definition of IRC 642(c)(5), e.g. funds which include investments in non-taxable securities, in which all properties are not commingled, in which a donor is serving as a trustee. Can such funds be retroactively qualified so as to take advantage of the three year rule? This question will presumably be answered by Treasury regulations.

8. *Effective Dates*

The new rules of IRC 2055(e) are applicable generally to decedents dying after December 31, 1969. This general rule is subject to several important exceptions stated in Sec. 201(g)(4)(B) and (C) of the Act:

Property passing under a will executed on or before October 9, 1969 is subject to the former rule if the decedent dies before October 9, 1972 without having republished the will by codicil or otherwise, or if the decedent had no right to change the charitable provisions in the will or was incompetent to do so.

Property transferred in trust on or before October 9, 1969 is covered by a similar rule, if the decedent dies before October 9, 1972 without amending the trust, or if the trust was irrevocable or could not be changed because of mental disability.

For existing wills and trusts the important date is October 9, 1972. If the document provides for a charitable remainder or charitable income interest, it must not now be amended by codicil or otherwise without considering the effect of the new rules of IRC 2055(e). If the testator wishes to amend his will or revocable trust for other reasons (e.g. to change or add a bequest to a particular person), he will have to make some decisions regarding the charitable transfers which do not qualify for the deduction under the new rules. The will or trust must of course be re-examined and revised in any case before October 9, 1972.

A prior transfer by a living donor under a life income contract would presumably be treated as a transfer to an irrevocable trust for purposes of applying the effective date rules.

> *Example:* Donor D transferred securities to X University under a life income contract. The income is payable to wife W for her life if she survives D. The securities are segregated and the payments to D and W are based on the income yield of the securities in this separate account. Under the new rule this will not qualify as a transfer to a pooled income fund, since the property transferred by all donors is not *commingled* in a common trust fund.

If the transfer was made before October 9, 1969, the Estate tax deduction at D's death, survived by W, is subject to the old rule and should be allowed. Act Sec. 201(g)(4)(C)(ii).

9. *Alternatives*

Consider the following alternatives in amending a non-deductible remainder interest following an income interest in a non-charitable beneficiary:

(A). Comply with the new rule by giving beneficiary W an annuity equal to 5% of the initial net fair market value of the trust property, instead of an income interest; or convert to a unitrust with a 5% annual pay-out based on an annual re-appraisal. The *annuity* is simpler and better protection for W in case of a drop in market values. The *unitrust* in which W's payments are based on a fixed percentage of the fluctuating value of the trust corpus complicates the trust administration (see (2) above); however this form may provide W with a hedge against inflation.

(B). Substitute an outright legacy or share of the residue for the charitable remainder, with no prior life or term interest in a non-charitable beneficiary. In place of W's income interest in the entire residue consider providing for the periodic invasion of the marital trust to supplement her income. If more cash flow is needed a reduced portion of the residue might be transferred to a charitable remainder annuity trust for W's lifetime benefit; or cash might be set aside outside the marital trust to purchase a commercial annuity for W.

10. *Disclaimer*

The Estate tax cost of a non-qualifying charitable remainder interest will be very high.

> *Example*: D's residuary estate is left in trust, income payable to W for her life, remainder at W's death to charity. At age 72 the value of W's interest under the 3½% table (Treas. Reg. §20.2031-7) is worth about 25% of the total residue. The charitable remainder is therefore worth 75%. If the residuary estate is worth $400,000 and the effective Estate tax rate is 35% the Estate tax liability will be increased by over $100,000 (35% of $300,000) if no deduction is allowed for the value of the reremainder. (This disregards the effect of tax compounding.)

This remainder interest, which does not qualify for the charitable deduction under the new rule, can be cured by a disclaimer of the intervening interest. IRC 2055(a). If W disclaims her income interest in this case the entire residue will pass directly to charity and a deduction will be allowed for the full $400,000. The disclaimer will not only cure the problem of the non-qualifying remainder interest; it will also have the effect of increasing the charitable deduction by converting the remainder interest to an outright transfer.

In some cases the amount of the Estate tax liability which will be saved by the disclaimer will greatly exceed the value of W's income interest, and the economics of the situation will make it important to find a satisfactory way for W to give up that interest. The extent to which her income interest can be replaced by other values, originating with the charity or from other beneficiaries affected by the tax remains to be seen.

11. *Charitable Income Interest*

IRC 2055(e) also limits the deductibility for Estate tax purposes of a term interest passing to charity at the decedent's death. The former rule allowed a deduction for the commuted value of a charitable income interest.

A charitable deduction is no longer allowed for an income or term interest to a charity followed by a non-charitable remainder "unless such interest is in the form of a guaranteed annuity or is a fixed percentage distributed yearly of the fair market value of the property (to be determined yearly)." No deduction is allowed for the transfer to charity of a *mere income interest.*

*Examples*:

A. Property in trust, *income* to charity for 20 years, remainder to Son S. Non-deductible under IRC 2033(e).

B. Property in trust, annual payments of *$1,000*, to charity for 20 years, remainder of income, if any, to Son S, corpus to be distributed to S at end of term. Commuted value of $1,000 per year for 20 years deductible under IRC 2033(e).

The limitation (like the new rule on charitable remainders) is subject to the effective dates summarized above in (8). If the transfer is made under a will executed on or before October 9, 1969 and not republished, the old rule will apply if the testator dies before October 9, 1972.

12. *Other Rules Unchanged*

Charitable gifts and bequests, in trust or otherwise, which do not follow or precede a non-charitable interest are unaffected by IRC 2055(e). If the charitable transferees or beneficiaries are "recognized" and their governing instruments are in order the Estate tax deduction with no percentage limitation is allowable under IRC 2055(a). This general statement of the Estate tax charitable deduction rule has not been amended, except to add a clause disallowing a deduction for transfers to organizations which engage in electioneering activities.

## PART II: THE PRIVATE CHARITABLE FOUNDATION

The Proposals submitted by both the Johnson and Nixon Treasury Departments in January and April 1969 to "reform" private charitable foundations plus some further restrictions added by the Congress, are now a part of the Internal Revenue Code. The new rules are scattered through the Code under various headings including the following:

*Exempt Organizations*
  IRC 507-509
    Special rules applicable to private foundations
*Miscellaneous Excise Taxes*
  IRC 4940-4948
    Tax in investment income
    Penalty taxes based on forbidden conduct
*Returns*—IRC 6033

*Annual Reports*—IRC 6056
*Public Inspection*—IRC 6104

Some of the tax advantages of the private foundation have been eliminated and others severely limited.

1. *Private Foundation as Public Trust: IRC 507*

This is the first section in the long series of new statutory rules governing charitable foundations. Ineptly titled "Termination of Private Foundation Status," the section may be read as a statement of the policy which underlies all the provisions which follow: Once assets have been committed to a private foundation—with tax benefits to its contributors based on Income, Estate and Gift tax deductions and to the organization based on its Income tax exemption—the assets are impressed with a public trust and cannot be diverted from charitable uses, without repaying to the government the amount of the tax benefits.

A private foundation may terminate its status by distributing all its assets to an established public charity or by itself qualifying as a public or semi-public charity (see definitions in (2) below). Otherwise the price of escape from private foundation status is the recapture of prior tax benefits. The recapture rule is stated as a tax equal to the aggregate tax benefits for all prior years with interest, up to the full value of the net assets of the foundation. The tax may be abated even after assessment, if all assets are then distributed to a public charity.

An existing organization may convert to public status during 1970 (or during its first taxable year beginning after 1969). After 1970 or such taxable year a 60-month period of public operation is required for final termination of private foundation status.

This statute is designed to prevent a charitable foundation from changing its tax exempt status, and at the same time retaining its assets, after providing its donors with valuable tax benefits. Normally a foundation will go out of existence by gradually distributing its assets, principal as well as income in "qualifying distributions" as defined in IRC 4942(g) —see (7) below. This would include transfers to semi-public charities and operating foundations (as well as public charities). It is not clear why the termination statute limits the final transferees to established *public* charities, excluding other charities which can receive qualified distributions of principal from the foundation prior to its "termination of status." This statute probably is not intended to apply unless the foundation attempts in some way to retain its assets while removing them from the public "trusteeship" contemplated by the private foundation rules. See part C under (10) below.

### 2. *Private Foundation Defined: IRC 509*

The term "private foundation" is defined in IRC 509 by exclusion. It includes any organization exempt from Income tax under IRC 501(c)(3) *except*:

A. Churches, educational institutions, hospitals, governmental units, and organizations supported by the general public—"public charities."

B. Organizations receiving more than one-third of their support from the public—"semi-public charities." The remainder of the support can come from one or more large contributors, except that not more than one-third can be from gross investment income.

C. Organizations operated and controlled by one or more public or semi-public charities described in A or B—the second tier charity or a community foundation collecting funds for public charities.

D. Organizations testing for public safety.

For charitable organizations other than churches, educational institutions and hospitals (and the public safety group), the classification depends on a support test—the extent to which the organization derives its "support" from the general public. The definition of "support" for class A, public charities, differs from the definition applied to class B, semi-public charities.

The statutory definition of a public charity (IRC §170(b)(1)(A)(vi)) corresponds with the former definition of so-called 30% charities, gifts to which qualified for the 30% limitation and carry-over. For this purpose "support" does not include amounts received by the charity in the performance of its charitable function. This would exclude admission fees, sales proceeds, etc. The former regulation, Treas. Reg. §1.170-2(b)(5), contains detailed rules and examples relating to the determination of "public support" and will presumably be applied under the 1969 Act.

In determining whether a class B charity receives more than one-third of its support from the public the term has a broader meaning. Under IRC 509(d) "support" includes gross receipts from admissions, sales, services and facilities, membership fees, as well as gifts, grants, contributions (excluding gifts from large contributors and disqualified persons) and investment income (excluding capital gains).

If the organization satisfies the applicable public support test (and in the case of a class B organization, receives less than one-third of its support from investment income), it will not be classed as a private foundation and will not be subject to the 4% excise tax (IRC 4940), public inspection, and various other special rules mentioned below.

### 3. *Operating Foundation Defined: IRC 4942(j)(3)*

This is a special privileged class of private foundations, still subject to the 4% excise tax, but free of the income distribution requirement of IRC 4942 discussed below.

The definition is based on the activities of the organization. To qualify as an operating foundation it must satisfy the following tests:

(A) Substantially all its net income, including exempt interest and short term capital gains (see IRC 4942(f) ), is spent in its active charitable operation—and

(B) Either—

(i) More than half of its assets are devoted to such activities, or

(ii) At least 2/3 of its "minimum investment return" is spent in such activities. This means for 1970 4% (2/3 of 6%) of the value of its investment assets IRC 4942(e).

This definition should cover most active (non-feeder) charitable organizations. It is explained and amplified in the Senate Finance Committee Report at page 60. Compare section 170(g) of prior law.

An operating foundation, even though entirely supported by its investment income or by one contributor or both combined, is exempt from the income distribution rule of IRC 4942 (discussed below), can receive qualifying income distributions from a private foundation (if not commonly controlled), and can receive gifts of appreciated securities and other capital assets from its contributors without subjecting them to a capital gain tax under IRC 170(e)(1)(B)(ii). For other purposes—the 4% excise tax, self dealing, excess business holdings, public inspection, etc. it is treated as a private foundation.

4. *Organization*

The "governing instrument" must include the requirement and prohibitions stated in IRC 508(e). Subject to a further review after the Treasury regulations are published the following clauses are suggested for inclusion in articles of incorporation and trust instruments:

As a private charitable foundation exempt from federal Income tax under IRC 501(a) the foundation shall be governed by the following provisions:

(A) The income of the foundation for each taxable year shall be distributed at such time and in such manner as not to subject the foundation to tax under IRC section 4942. (Not applicable to an operating foundation.)

(B) The foundation shall be prohibited from engaging in any act of self-dealing (as defined in IRC section 4941(d)), from retaining any excess business holdings (as defined in IRC section 4943(c)), from making any investments in such manner as to subject the foundation to tax under section IRC 4944, and from making any taxable expenditures (as defined in IRC section 4945(d)).

For existing organizations, created before January 1, 1970, the governing instrument rule of IRC 508(e) does not apply to taxable years beginning before 1972. Such organizations can wait until the regulations are published before amending their governing instruments.

5. *Recognition*

Under IRC 508(a) a notice must be filed with the Internal Revenue Service stating that the organization is applying for recognition as an exempt charitable organization. This is now a pre-requisite to exemption and to the deductibility of contributions (IRC 508(d)). The notice procedure will be prescribed by Treasury regulations. The time for filing the notice will not expire until 90 days after the regulations become final.

6. *Excise Tax*

IRC 4940 imposes an annual excise tax of 4% on the "net investment income" of a private foundation. The tax base includes all ordinary investment income (interest, dividends, rents, etc.) plus net capital gains, based on the value of assets held on December 31, 1969 if higher than cost or basis. Investment expenses including straight line depreciation are deductible. Capital losses are not deductible except against capital gains. Exempt income and related expenses are not included in the tax base. The excise tax is effective in taxable years beginning after 1969.

> *Example*: In 1970 Foundation A receives dividends and net rental income (after expenses and straight line depreciation) of $20,000. In September 1970 it sells stock of GM Co. for $12,000. This stock was held at a basis (cost or donor's basis) of $6,000 and was worth $10,000 on December 31, 1969. Net investment income is $22,000 ($20,000 plus $2,000 capital gain). The excise tax (4%) is $880.

7. *Income Distribution: IRC 4942*

A private non-operating foundation—a feeder foundation—is required to use or distribute its entire "adjusted net income," currently or not later than the end of the following year. Any income not so used or distributed, is subject to a 15% tax. Income is defined to include exempt interest and net short term capital gains, in addition to ordinary investment income. Expenses attributable to such income, including straight line depreciation for rental property, are deducted.

Beginning in 1972 an alternative test for determining the "distributable amount" becomes applicable. For years beginning in 1972, 1973 and 1974 the minimum amount is 4½%, 5% and 5½% of the net value of the foundation's investment assets, if this "minimum investment return" is higher than "adjusted net income." For years beginning after 1974 the percentage is 6%, subject to change by the Treasury depending on "money rates" and "investment yields." The transition rules are stated in Section 101(L)(3) of the Act.

Qualifying distributions are defined in IRC 4942(g) to include administrative expenses, contributions to public and semi-public charities and operating foundations, cost of acquiring an asset to be used in the operations of the foundation, e.g. furniture and equipment for office. A transfer to a subsidiary or commonly controlled organization does not count as an income distribution unless the transferee uses in its own operations, or distributes an equal amount as corpus before the end of the following year. A distribution is chargeable to corpus after all income of the last preceding and current years has been used or distributed.

The foundation can obtain permission from the Revenue Service to set aside income for a long range project for up to 5 years (subject to extension), on a showing that the project "can be better accomplished by such set-aside than by immediate payment of funds."

A five year carry-forward is provided for excess distributions after 1969.

### 8. *Prohibited Actions*

The old prohibited transaction rules are replaced by a series of statutory prohibitions, enforced by tax penalties based on a percentage of the cost or value of property involved in the transaction.

#### A. Self-Dealing: IRC 4941.

Transactions between the foundation and a "disqualified person" are generally barred. This includes sales, exchanges, leases, loans, furnishing goods, services and facilities, payment of compensation.

The term "disqualified person" is defined in IRC 4946 to mean a substantial contributor or a member of his "family" defined in subsection (d), a foundation manager defined in subsection (b)—officer, director or trustee—related corporations, partnerships and trusts, and some others. The term "substantial contributor" is defined in IRC 507(d)(2) to mean a person contributing more than $5,000 if this is more than 2% of cumulative total contributions determined at each year end.

The self-dealing statute lists a few exceptions: A disqualified person may lend money to the foundation *without interest* and may furnish to the foundation goods, services and facilities *without charge*, provided the loan proceeds and the goods, services or facilities are used for charitable purposes. The foundation may furnish goods, services and facilities to a disqualified person on a basis no more favorable than that available to the general public, and may pay reasonable compensation to a disqaulified person for necessary services. These exceptions are stated in IRC 4941(d)(2).

Under a transition rule leases, loans and sharing arrangements in effect on October 9, 1969, may be continued for up to 10 years, provided the arrangement is "not disadvantageous" to the foundation. Act Section 101(L)(2)(D), Senate Report p. 34.

B. Excess Business Holdings: IRC 4943.

In general a private foundation may not hold stock (voting or non-voting) in a corporation controlled by disqualified persons (substantial contributors, etc). The holdings of the foundation combined with the holdings of all disqualified persons may be as much as 20% of the voting stock, or 35% if other persons are actually in control; and non-voting stock may be held by the foundation if the voting stock is within these percentage limitations. Similar rules apply to partnership interests. Under a *de minimis* rule foundation ownership of up to 2% of the voting stock and value of non-voting stock is permitted.

The effect of these rules will be to prohibit a private foundation from owning more than 2% of the stock of a corporation owned and controlled by its major contributors.

The percentage limitation for the foundation and all disqualified persons is increased to 50% for holdings as of May 26, 1969. Excess holdings as of that date are permitted for periods of 10 to 20 years (and even longer during a "second phase" period), depending on the percentages. A special period of years is allowed for disposition of excess holdings acquired by gift or bequest. IRC 4943(c)(5) and (6).

IRC 537 defining "reasonable needs of the business" for purposes of the accumulated earnings tax, has been amended to include the amount required to redeem stock owned by a private foundation on May 26, 1969 which constituted "excess business holdings," or to pay off an obligation incurred to make the redemption. Such excess holdings (owned on May 26, 1969) are also exempted from the self dealing rule (IRC 4941) and may be sold or redeemed for not less than fair market value in a transaction with a "disqualified person." Act Sec. 101(L)(2)(B). This will permit the redemption of the stock by the issuing corporation even though controlled by a major contributor. And the redemption proceeds received by the foundation from the issuing corporation are not treated as dividend income under IRC 302(b)(1) for purposes of IRC 4942(f), the income distribution rule. Act Sec. 101(L)(3)(D). This means that such proceeds may be retained as principal and will not have to be distributed currently by the foundation under the income distribution rule (see (7) above).

C. Investments Jeopardizing Charitable Purpose: IRC 4944.

The former rule on "jeopardy" investments (IRC 504(a)(3) ) applied only to accumulated income, and the only sanction was loss of the Income tax exemption. The new rule applies to all foundation funds and the sanction is a 5% tax on the amount of the improper investment, (e.g., speculative investments in stock warrants, commodity futures, margin transactions —see Senate Finance Committee report, page 45). The Committee report also makes it clear that program related investments—e.g., student loans, low income housing—are not prohibited. The sale of an investment removes it from jeopardy. IRC 4944(e)(2).

D. Taxable Expenditures: IRC 4945.

A 10% tax is levied on certain prohibited expenditures relating primarily to propaganda and political activities. The statute also bars grants to *individuals* for study, travel, etc. unless awarded "on an objective nondiscriminatory basis" pursuant to a procedure approved in advance by the Revenue Service. See subsection (g) of IRC 4945.

E. Correction Period.

Although the penalty taxes for violating these prohibitions are very severe a "correction period" is provided in each case during which the violation may be cured and the penalty reduced or eliminated.

9. *Reports—Public Inspection*

Every private foundation having at least $5,000 of assets at any time during the year is required by IRC 6056 to file a report for each year with the Internal Revenue Service containing:

> Financial information—income, expenses, beginning and ending balance sheet listing assets at book and market values
> Total contributions received
> List of grants and contributions paid out or approved, stating purpose of each
> Names of "foundation managers" (officers, directors, trustees)
> List of "substantial contributors" ($5,000 or 2% of cumulative total contributions determined at each year end.)

This report is in addition to the information returns required under IRC 6033 to be filed by all exempt organizations.

The detailed report prescribed by IRC 6056 is made available "for inspection at the office of the foundation during regular business hours by any citizen on request made within 180 days after the publication of notice of its availability." The notice of availability must be published not later than the filing date "in a newspaper having general circulation in the county in which the principal office of the private foundation is located." IRC 6104(d). The extent to which this right of inspection will be taken advantage of by local individuals, with or without a legitimate reason, remains to be seen.

10. *Practical Operation of New Rules*

A. Existing Foundation Funds.

Apart from the special problems presented by "excess business holdings" (e.g. stock of a closely held corporation controlled by a major contributor) it will not be difficult to comply with the rules and avoid the harsh sanctions and penalty taxes.

Foundations do not ordinarily engage in business transactions with their contributors or trustees (self dealing), do not make speculative (jeopardy) investments, and do not contribute money for propaganda or political purposes (taxable expenditures). Most private foundations make "qualifying distributions" (IRC 4942) each year considerably in excess of current income and in excess of the 6% "minimum investment return" which becomes fully effective in 1975.

It will not be difficult to comply with the formalities, after the regulations are published, for obtaining (or retaining) "recognition" as an exempt charity, and the magic words prescribed by IRC 508(e) can easily be inserted in the foundation's governing instrument.

The two new burdens or penalties which cannot be avoided by good conduct are the 4% excise tax on investment income and the public inspection rule. These two new requirements, coupled with the prospect of frequent examinations by an elite corpus of government agents, will move the founders and trustees of many private non-operating foundations to seek ways and means of transferring funds and assets to other charitable organizations not subject to these rules.

Substantial funds are likely to flow from private foundations into the endowment funds of established institutions. To the extent that trustees of a private foundation are not prepared to select the ultimate distributees of its capital funds, the community foundation supported by public contributions may be the ideal transferee.

A feeder foundation can undoubtedly convert to an operating foundation by shifting into direct charitable operations which will absorb its entire income—running a school, developing a student loan program, rehabilitating a slum area, etc. This will avoid the income distribution rule and will qualify the foundation to receive gifts of appreciated securities with tax benefits to the contributors, but it will not avoid the 4% excise tax, public inspection and other private foundation rules.

For a donor who wishes to retain control of the distribution of foundation funds and to leave control in his family after his death, the private charitable non-operating foundation can still serve a useful purpose, at least for the administration of existing funds and future cash contributions, recognizing that a 4% tax must be paid on all investment income.

B. Stock of Family Corporation.

The disposition of "excess business holdings" is a long range problem. Eventually, over periods upwards of 10 years, the holdings of the foundation in a corporation (or business enterprise) owned and controlled by disqualified persons (defined in IRC 4946) must be disposed of (or reduced to a 2% interest).

The sale or redemption of the foundation's holdings is facilitated by an amendment to IRC 537 permitting the corporation to accumulate funds for this purpose, and by other provisions exempting the transaction from the prohibition against self dealing and permitting the foundation to retain the proceeds as principal.

If the corporation pays modest dividends in relation to its earnings it may be advisable to eliminate the foundation's holding before 1972 when the "minimum investment return" rule takes effect at 4½%. The value of the stock included in the foundation's investment assets will affect the amount required to be distributed under IRC 4942 (see (7) above). This will be unimportant if the foundation expects to make "qualifying distributions" for charitable proposes well in excess of its net investment income.

In general the disposition of existing holdings (owned on May 26, 1969) will not present a serious problem for most foundations. In fact the requirement that these shares must eventually be redeemed will provide the issuing corporations with an additional defense against the assertion of an accumulated earnings tax penalty.

For the future, stock in a closely held corporation will not be an appropriate investment for foundation funds. The transaction would probably be prohibited as "self dealing" (IRC 4941) and if the acquisition added to or created an "excess business holding" (IRC 4943) the shares would have to be disposed of forthwith in any event. A 5-year period is provided for the disposition of excess stock acquired after May 26, 1969 by gift or bequest (IRC 4943(c)(6)) but this does not apply to stock purchased by the foundation.

C. Termination of Existence.

The foundation can go out of existence gradually or at one time by making qualified distributions of principal as well as income to public and semi-public charities. This is probably not the sort of termination which is covered by the "termination of status" rule discussed in (1) above. If this latter statute (IRC 507) applied the final terminating distributions would have to be confined to public charities. This question will undoubtedly be cleared up by the regulations.

A final information return is required by new IRC 6043(b) to be filed by every private foundation (and some other exempt organizations) reporting its "liquidation, dissolution, termination or substantial contraction." The form of report will be prescribed by regulations. This subsection is an addition to the statute requiring a business corporation to report the adoption of a plan of liquidation.

D. New Foundation Funds.

One important source of funds for private non-operating foundations has been cut off by IRC 170(e)(1), which requires a taxpayer contributing appreciated securities to a private non-operating foundation to reduce his Income tax deduction by 50% (62½% for a corporate contributor) of the appreciation—in effect taxing the contributor on his unrealized capital gain. Cash gifts are still deductible subject to the 20% limitation. The rule of IRC 170(e)(1) does not apply to securities transferred to a private *operating* foundation.

For Gift and Estate tax purposes the outright transfer of funds and properties to a private foundation or any other recognized charitable organization are fully deductible, with no percentage limitation and no capital gain tax on the appreciation in value.

The extent to which new funds and properties will flow from decedent's estates into private foundations or into charitable trusts which are treated as foundations will depend upon the factors mentioned above, primarily the 4% excise tax on investment income, the public inspection rule and the prospect of frequent governmental examinations.

A qualified charitable foundation may be used as a transitional entity to receive a bequest or share in the residuary estate, and distribute the funds among established institutions selected by the foundation trustees after the decedent's death. If the distribution can be carried out over a relatively short period the excise tax shrinkage (4% of investment income) will be negligible and the other disadvantages will not be serious.

Another alternative will be to name a community foundation as the distributee instead of a private foundation, leaving it to the distributing committee of the community organization to select the ultimate distributees of income and principal.